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SUBJECT: ITALY'S PUBLIC DEBT - NO PIIGS HERE

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¶1. Summary -- The 2008 financial crisis and ensuing recession have strained many Western European governments' finances, including Italy's. While the Italian debt picture is troubling, it is Post's view that the problem is manageable in the foreseeable future, and unlikely to deteriorate in the manner of the ongoing emergency in Greece and similar ones in Portugal, Ireland and Spain (PIIGS). Trends in the maturity and interest rate cost of Italy's debt are favorable, as is the profile of Italy's creditors. In the long run, however, Italy's debt load will sap investment and stifle growth, contributing further to decades-old Italian economic malaise. End Summary.

Public Debt Balloons

¶2. Italy's public debt, at 1.75 trillion euros (2.45 trillion USD) is the third largest in the world, after the US and Japan. Officially estimated at 115.1 percent of GDP at end-2009, it is the highest of any major economy in the euro zone and almost double the 60 percent limit stipulated by the EU's Maastricht treaty.

¶3. Throughout the eighties Italy's public debt almost doubled, from about 60 percent of GDP in 1980 to a record high of 122 percent in ¶1994. Between 1994 and 2000 Italy's public debt fell back to 100 percent of GDP, in large part due to a broad economic privatization program, but anemic economic growth pushed it up again to 105.8 percent in 2008, the eve of the financial crisis. The crisis and the ensuing recession pushed this ratio to 115.1 percent at end-2009, now projected to increase further to 117 percent in 2010.

¶4. Despite this bleak trend, the Italian government appears capable of servicing existing obligations and of raising additional funds in capital markets to meet expected budget deficits of around 5 percent of GDP in 2010 and 2011. (Note: Greece's 2009 budget deficit by comparison, exceeded 12 percent of GDP). Capital markets and sovereign credit rating agencies seem to concur in this assessment.

Just 84 Easy Payments

¶5. There are a number of factors suggesting that the GOI's debt problem will be manageable in the foreseeable future. The first is the average maturity of the debt stock, currently at seven years. Throughout 2009, in fact, average maturity increased from 6 years and 8 months, as the GOI resorted to issuing longer term securities. Second, Italy's debt servicing capacity remains stable, as in 2009 the GOI astutely continued to issue bonds beyond its immediate needs, capitalizing on favorable market conditions. According to

Bank of Italy officials, the Italian Treasury currently has 31.7 billion euros (about two percent of GDP) on reserve in the Bank.

¶6. The third factor in the GOI's favor is the declining interest cost of its debt. The average interest rate Italy pays is five percent and falling, with recent (2009) 1-year Treasury notes yielding (based on the initial discount) less than one percent on average (a negative real interest rate), and new longer term issues yielding on average 3.5 percent. Finally, forty-five percent of Italy's debt is held by foreign investors, which suggests the GOI has a broad and diversified pool to tap for funds.

The Market Agrees

¶7. The international capital market appears to concur in this moderately favorable assessment, given the spread between the interest rate the German government pays on its benchmark 10 year bonds, and that paid by the GOI. While the "Bund" spread widened to a post-euro record 159 basis points in January 2009, it narrowed to 75 basis points by early 2010. In fact, in the secondary market, Italian debt was the best-performing of the 16-nation euro region this year, gaining 8.1 percent, according to Bloomberg/EFFAS indexes.

¶8. The credit rating agencies throughout 2009 similarly maintained Italy's sovereign ratings well in the investment-grade range, with Standard and Poor's assigning a "stable" outlook. While the cost of credit default swaps on Italian debt rose slightly in mid December 2009 from 86 to 94 basis points, it remains well below the recent 390 basis points cost to insure against Greek default.

Some Cause for Concern

¶9. (SBU) Central bank officials told econoffs on January 14 that only 10 percent of Italy's debt is short-term, i.e. due in one year or less. That 10 percent, however, comes to 170 billion euros. Fortunately, the massive liquidity injection by central banks world-wide means that short-term investment funds remain plentiful, and the GOI should be able to roll over its short-term debt fairly easily, barring a new shock to the international financial system.

¶10. (SBU) Another development to watch is the growth of Central Bank lending to the GOI, which during 2009 increased from 20.3 billion euro to 49.4 billion euro, according to Bank officials.

Comment: A Permanent Drag on Growth

¶11. (SBU) Notwithstanding the international press' smug new acronym (PIIGS) that lumps together assorted highly indebted Euro-zone nations, Italy's situation is decidedly not/not another Greece in the making. The likelihood of a similar short-term debt crisis here is very small.

¶12. (SBU) Still, Italy's massive debt hangover augurs badly in the medium and long run. Absent fundamental economic structural reforms, Italy will continue to struggle under a huge debt burden. In the best of cases, it will constitute a permanent drag on growth, whether by crowding out productive private investment, or dampening GDP as a result of higher taxes and/or lower spending to control deficits. Italy's only option is to grow its way out of its debt load, but already-high taxes, excessive regulation and disincentives to investment make this an unlikely prospect.
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